# Dutch housing finance market

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## Dutch housing finance market: overview

### Defining characteristics

#### *Government interference*

Developments in the Dutch housing market are clearly influenced by the fiscal regime, which has induced both lenders and borrowers to maximise mortgage interest deductibility (“fiscal arbitrage”) and has stimulated mortgage equity withdrawal. It has contributed to the rapid debt take-up by Dutch households and the increase of loan-to-value ratios. In the past few years, various governments took some steps to reduce the generosity of this fiscal regime, but a more fundamental phasing-out of the scheme (as recommended by the IMF and the OECD) remains a highly sensitive political issue. The rental market is influenced by the government too: as the majority of rental homes is owned by quasi-public institutions, many renters receive housing benefits and the annual rate of rent increases is capped. The functioning of the (social) rental market seems to be distorted by regulation.

#### *Borrowing and contract types*

Dutch homeowners have a large variety of mortgage products they can choose from. In combination with the liberalisation of and competition in the mortgage market, the fiscal regime has contributed to the introduction of new mortgage products that refrain from loan redemption until maturity. Around 90% of the mortgage loans extended since 1995 are not repaid until maturity and around 30% do not have to be repaid at all (“interest-only”). The Dutch housing market is dominated by fixed rate borrowing. However, the average (remaining) term of fixed rate mortgages is on a decreasing trend and the share of variable mortgages seems to be growing recently. In all income groups, 35-45% of households have a remaining fixed rate term shorter than two years. Mortgages can be refinanced at the cost of a penalty, but in practice not all the costs faced by lenders are passed on, and - by law - 15% of a mortgage loan can be repaid without charge each year.

#### *Lending and funding*

Banks dominate the Dutch mortgage market with a stable share of around 70%, while the share of institutional investors is expanding. The market is quite concentrated, as three banks hold around half of the mortgage credit outstanding. Recently, mortgage lending growth accelerated to around 10%. In general, securitisation of mortgage loans by Dutch banks is still limited compared to their balance sheets. The rapid rise in the amount of loans being securitised, however, is a reflection of financial institutions’ more active risk management in recent years. The involvement of (quasi-) public chartered institutions in housing finance is limited.

#### *Regulation*

The Financial Markets Authority has set standards on the information that must be provided by mortgage lenders. Since 1 July 2002, financial institutions have to provide a Financial Information Leaflet to consumers who consider purchasing “complex financial products”. Moreover, the mortgage branch itself has compiled a number of guidelines and best practices (Mortgage Code of Conduct). In the Netherlands, under the Civil Code and Code of Civil Procedure, mortgage lenders have full recourse against borrowers who have defaulted on mortgage payments. This legal protection acts as a

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strong disincentive to default and limits the potential losses for lenders. The current solvency requirements for Dutch banks regarding mortgage loans provide for a distinction according to the (perceived) riskiness of these loans.

### *International links*

While the presence of foreign institutions in the Dutch mortgage market is still quite small, their activities are expanding rapidly. Their strategies focus on competitive pricing via internet and possibly also on granting less strict lending criteria. The major Dutch banks undertake substantial mortgage lending activity abroad. The involvement of international rating agencies in the Netherlands is considerable; larger banks rely on rating agencies when issuing securitised products such as mortgage-backed securities.

## Main developments and trends over the past 10-15 years

Dutch house prices accelerated in the 1990s, followed by a gradual cooling-down. Since 1990 house prices have grown much more strongly than average inflation or rent levels. When deflated for CPI or nominal GDP, house prices still seem to be at historically high levels. The house price boom of the 1990s can be attributed to favourable cyclical conditions, a sustained period of low interest rates, low supply elasticity of new dwellings, the fiscal regime, liberalisation of and growing competition in the mortgage market, stock market developments and demographic factors. These factors also led to the rapid build-up of mortgage debt by Dutch households.

The house price-to-income ratio has stabilised in the past few years, although its level is still high from an international perspective. The effects of rising house prices on affordability have been mitigated by favourable financing conditions. While the average housing cost-to-income ratio for homeowners has been quite stable since 1995, there seems to be a dichotomy between *movers*, who profited from the earlier house price boom and have surplus value, and *starters*, who have no surplus value and fewer financial buffers. Since 1990, net wealth of the Dutch household sector has grown substantially, with residential property (and pension wealth) more and more dominating the sector's balance sheet. Therefore, the financial wealth of Dutch households has become more sensitive to fluctuations on the housing market. In the past decade, (procyclical) spillover effects from the housing market to the Dutch economy, reinforced through mortgage equity withdrawal, played an important role.

## Key housing finance policy questions for central banks

Based on experiences in the Dutch housing finance market, in our view central banks/supervisors face the following key (global) housing finance policy questions:

### *Risks to households*

- From a historical perspective, households are highly indebted due to the rapid build-up of mortgage debt. In addition, (remaining) fixed rate terms of mortgage loans are on a decreasing trend. Interest rate risks stemming from mortgage loans seem to have shifted partially from mortgage lenders to households. Faced with possible shocks like a strong rise in unemployment or a rapid interest rate rise, could both the probability of default and the severity of default of (home-owning) households turn out to be much higher than historical data would suggest?

### *Spillover effects to the macroeconomy and monetary policy transmission*

- As household wealth has become more sensitive to fluctuations in the housing market, how strong are spillover effects from the housing market on consumer spending and GDP growth and are they procyclical?
- What are the consequences for (international differences in) monetary policy transmission?

***Risks to financial institutions***

- Has the low interest rate environment induced mortgage providers to expand their mortgage lending? Does the growing share of mortgages in banks' portfolios point to higher concentration risks? Does the increased amount of mortgages extended at low rates lead to higher interest rate risk for mortgage providers? Are banks underestimating credit risks on households, because their internal models underestimate the probability and severity of default of households? Are banks sufficiently capitalised to cope with a strong correction of house prices?

***Spillover effects from/to financial markets***

- To what extent does the hedging of interest rate risks by mortgage lenders and the growth of MBS markets influence (national) housing finance systems and what are possible spillover effects to other financial markets?

***Housing finance structure***

- To what extent are housing finance markets influenced by government policies (taxation, repayment options) and what effects will a (further) harmonisation of those policies have?

## Dutch housing finance market: background[2]

### The housing market

The development of Dutch house prices in the past decade can be characterised by accelerating price increases up to 2000, followed by a gradual cooling-down. At the peak of the housing boom, in 1999 and 2000, house prices increased by 15-20% annually. Since 1990, house prices have risen much more than average inflation or rent levels (Chart 1a). Only recently, the pace of growth in rent and house prices seems to have become synchronised. In real terms, house prices have become significantly higher than the earlier peak value of the late 1970s, a level that proved unsustainable at the time (Chart 1b). While this may be a sign of excessive house prices, it can also be largely the effect of quality improvements in the housing stock. A crude way to take this into account is to deflate house prices by nominal GDP as an overall welfare indicator, which still leads to a level substantially higher than in the early 1990s. The house price boom of the 1990s can be attributed to several macroeconomic factors, such as favourable cyclical conditions, a sustained period of low interest rates and low supply elasticity of new dwellings. The generous fiscal regime has also played its role, in combination with the liberalisation of the mortgage market and growing competition between mortgage suppliers. Finally, developments in the stock markets and demographic factors contributed to the boom. These factors also led to the rapid build-up of mortgage debt by Dutch households in the last 10-15 years. In the period 1990-2003, the mortgage debt-to-GDP ratio increased from 35% to 86%.

The strong increase in mortgage debt has been fuelled by the Dutch fiscal regime, which permits full tax deductibility of (most) mortgage interest payments at the marginal tax rate. This has induced both lenders and borrowers to maximise mortgage interest deductibility ("fiscal arbitrage") and has stimulated mortgage equity withdrawal. In combination with the liberalisation of the mortgage market and competition between mortgage providers, this has led to the introduction of new mortgage products that refrain from loan redemption until maturity. Around 90% of mortgages extended since 1995 are not repaid until maturity of the loan and around 30% do not have to be repaid at all ("interest-only"). In addition, competition led to the loosening of lending criteria, such as the inclusion of secondary and temporary incomes in determining borrowing capacity. All these factors have facilitated debt take-up by Dutch households and have led to an increase of loan-to-value (LTV) ratios. The

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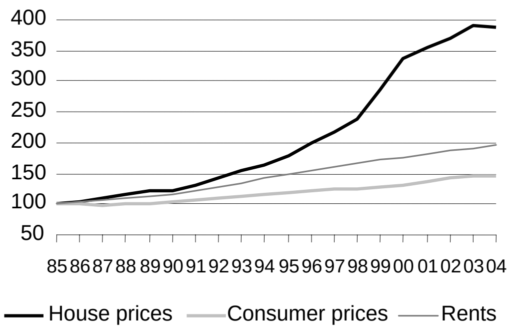
share of mortgages with an LTV over 100% increased from around 15% in 1990 to more than 70% in 2001/02.

Chart 1a

**House prices, rents and inflation**

Indices, 1985 = 100

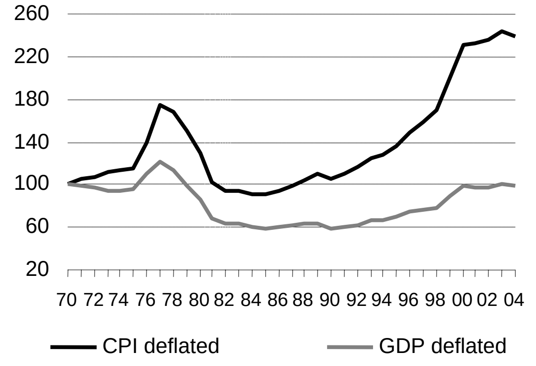



Sources: Statistics Netherlands; Kadaster; Netherlands Bank.

Chart 1b

**Real house prices**

Indices, 1970 = 100




Source: Statistics Netherlands; Kadaster; Datastream.

It is possible that revisions of the mortgage interest deductibility scheme in the past few years played a role in the recent cooling of the housing market. Under the scheme, all interest expenses were originally fully deductible at the marginal tax rate. The government has now taken some steps to reduce the generosity of the scheme. First, tax deductibility has been limited to interest payments on mortgage loans that are used for the improvement of a house (ie not for other consumption or investment purposes), while mortgages for second homes have been excluded. Second, interest deductibility has been limited to a period of 30 years. Finally, on January 1 2004 the so-called *bijleenregeling* (regulation for “additional lending”) came into force: homeowners moving to a more expensive dwelling are supposed to use capital gains on their former house as a “down payment”.

Besides fiscal deductibility of mortgage interest, the housing market is influenced by other forms of government intervention. Capital gains on own property are not subject to taxation. The (change in) value of own property will have a modest influence on the homeowners tax bill, though, because the imputed market-based rental value of property is added to taxable income. Moreover, homeowners have to pay property taxes to local governments, which have risen quite sharply in some municipalities. Finally, own property movers have to pay transfer tax (6% of the purchase price). The rental market in the Netherlands is influenced by government regulation as well. The majority of rental homes are owned by quasi-public institutions (housing associations). Government policy allowed the sale of up to 50,000 housing association units per annum, but between 1998 and 2002, only 15,000 dwellings were sold annually. Many renters receive housing benefits from the government, to keep their rent-to-income ratio within certain limits. In addition, a maximum annual rate of rent increase is set by the government. Altogether, the functioning of the (social) renting market seems to be distorted by government regulation, which has led to a lack of circulation in this market.

With the recent cooling of the housing market, the house price-to-income ratio has stabilised the past few years, although its level is still high from an international perspective. In general, the effects of rising house prices on affordability have been mitigated by favourable financing conditions: low levels of mortgage interest rates, shortening of interest rate terms, and a growing share of redemption-free mortgages. The average living cost ratio for homeowners has been quite stable at 24% since 1995. However, regarding affordability there seems to be a dichotomy between *movers*, who profited from the earlier house price boom and have surplus value, and *starters*, who have no surplus value and fewer financial buffers. The cost of living ratio for starters in the homeowners market (young entrants) clearly has risen the past 10 years. Young entrants find it more difficult to purchase their own dwelling. While the share of homeowners among Dutch households has risen, from 47% in 1993 to 54% in 2002, the increase in home ownership among young entrants is much less.

Developments in the housing market dominate the balance sheet of the Dutch household sector (Table 1). Since 1970, aggregate household wealth in the Netherlands has nearly doubled, while its composition has changed significantly. Residential property has become the most important asset of Dutch households, due to the gradual increase in home ownership and the rapid increase in house prices in the 1990s. The rapid growth of mortgage debt is reflected on the liability side of the balance sheet. Altogether, the financial wealth of Dutch households has become more sensitive to fluctuations in asset markets, particularly through residential property, mortgages and pension wealth. Spillovers from asset price volatility to the Dutch economy, especially through mortgage equity withdrawal, have played an important role the last decade, creating a procyclical effect on spending and GDP growth. Internal calculations with the Nederlandsche Bank's macroeconometric model show that mortgage equity withdrawal had a positive effect on GDP of 0.5-1 percentage point in 1998-2000, turning into a *negative* contribution of 0.5 percentage points in 2001.

Table 1

**Balance sheet of Dutch household sector**

As a percentage of GDP

| | 1970 | 1980 | 1990 | 2000 | 2003 |
|---|---|---|---|---|---|
| *Assets* | | | | | |
| Liquid financial assets | **108** | **69** | **84** | **114** | **90** |
| Cash | 7 | 5 | 7 | 4 | 3 |
| Deposits | 15 | 14 | 16 | 19 | 18 |
| Savings | 28 | 32 | 34 | 33 | 41 |
| Bonds | 35 | 10 | 8 | 7 | 11 |
| Equity | 23 | 7 | 19 | 50 | 17 |
| Residential property | **59** | **111** | **98** | **194** | **220** |
| Pension wealth | **47** | **62** | **103** | **164** | **150** |
| Other illiquid assets | **61** | **34** | **38** | **38** | **32** |
| Private equity | 32 | 16 | 17 | 16 | 11 |
| Small enterprises | 20 | 10 | 14 | 14 | 13 |
| Land and other real estate | 9 | 7 | 7 | 8 | 7 |
| Total | **276** | **276** | **323** | **509** | **491** |
| *Liabilities* | | | | | |
| Debts | **24** | **45** | **52** | **92** | **108** |
| Mortgages | 15 | 29 | 35 | 71 | 86 |
| Consumer debt | 2 | 4 | 3 | 5 | 5 |
| Other debt | 7 | 12 | 13 | 16 | 17 |
| Net liquid financial wealth[1] | **84** | **24** | **32** | **22** | **–18** |
| Net wealth | **252** | **231** | **271** | **417** | **383** |
| Total | **276** | **276** | **323** | **509** | **491** |

[1] Liquid financial assets minus total debt.

Sources: Statistics Netherlands; CPB.

### Borrowing and contract types

The Dutch mortgage market is dominated by fixed rate borrowing: 86% of outstanding mortgage debt is based on a fixed interest rate (Table 2). The majority of mortgages still have fixed rate terms of five or 10 years. The share of variable mortgages did not increase in the last decade, although very recent figures show that this share increased in the course of 2004. In addition, the average term of fixed rate mortgages is on a decreasing trend: five-year fixed terms have taken over the lead from 10-year fixed terms. According to figures for 2004, within four years, 55% of all mortgages are to be renewed; in 2003, this was 45%.

As explained above, the fiscal regime, in combination with the liberalisation of the mortgage market and competition between mortgage providers, has led to the introduction of new mortgage products which maximise the fiscal deductibility of mortgage interest. Interest-only mortgages are now dominant (Table 2), while traditional annuity and linear mortgages are out of fashion. "Hybrid forms" (savings and investment mortgages) are also popular: borrowers have to contribute monthly to a savings or investment account and the proceeds thereof are used to finance redemption at maturity.

Table 2

**Mortgage products: 1994 and 2004**

As a percentage of total mortgage debt outstanding

| | **1995** | **2004** |
|---|---|---|
| *Interest* | | |
| Fixed | 86 | 86 |
| Variable | 14 | 14 |
| Total | 100 | 100 |
| *Mortgage type* | | |
| Annuity and linear mortgage | 24 | 6 |
| Savings mortgage | 34 | 22 |
| Investment mortgage | 21 | 25 |
| Interest-only mortgage | 14 | 40 |
| Other | 7 | 7 |
| Total | 100 | 100 |

Source: The Nederlandsche Bank.

In the Netherlands, the typical maturity of mortgage loans is 30 years. Mortgages can be refinanced at the cost of a penalty. Banks could demand a "penalty clause" as compensation for missing future interest receivables. In practice, however, prepayment risk can result in additional costs for lenders, because only a proportion of yield maintenance fees are recovered.[3] In addition, by law 15% of a mortgage loan may be repaid without charge each year, while prepayment due to moving home is also exempt from charges.

## Lending and funding

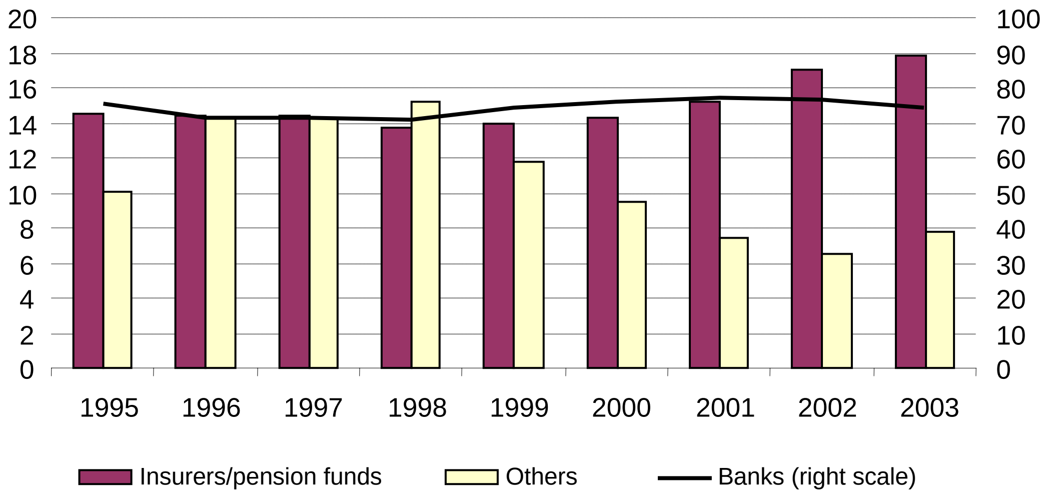
In the Netherlands, the mortgage market is dominated by banks. In 2003, mortgage lending by those banks accounted for 74% (EUR 364 billion) of the market, against 18% for pension funds and insurance firms and 8% for other institutions such as mortgage shops, investment firms, municipalities and provinces. Over the past 10 years, the predominance of banks has remained relatively stable, while institutional investors have expanded their market share at the cost of other institutions (see Figure 1). The concentration rate in this market is substantial, as the top three banks hold 51% of the mortgage credit outstanding. Preliminary figures for 2004 confirm that this trend has continued. Remarkably, mortgage lending recently resumed its strong growth to around 10% in the second half of 2004.

[3] M O Wyman (2003), *Study on the financial integration of European mortgage markets*, European Mortgage Federation, Brussels.

Chart 2

**Mortgage credit outstanding**

Market share (%)




Sources: The Nederlandsche Bank; Statistics Netherlands.

Securitisation of loans by Dutch banks is not significant yet, but the amount of loans securitised is growing rapidly, with 18% in 2004 (2000: 3%), and some individual banks have securitised a substantial part of their mortgage book (15-30%).[4] The emergence of securitisation - and more generally, the increasing use of credit risk transfer (CRT) instruments - is a reflection of institutions' more active risk management in recent years.

Since the 1988 Basel Accord, most banks have made gradual improvements in the way they measure, price and manage credit risks. Consequently, banks' risk awareness has been enhanced. Further progress in banks' risk management, in particular regarding their internal credit risk modelling, is under way as banks are investing heavily in these models in anticipation of the implementation of Basel II. Institutional investors have made similar progress in risk management, also partly driven by regulatory developments. In 2007, the Nederlandsche Bank will introduce the Financial Assessment Framework which has as a key objective to establish a solvency system that better matches the true risks of institutional investors.

With respect to credit risk assessments, when evaluating mortgage loans, all mortgage providers (banks and intermediaries) check the (re-)payment capacity of the clients in question. Moreover, the value of the collateral for securing interest and amortisation payments is assessed. An important factor in determining the (re-)payment capacity is that the maximum mortgage loan is based on a ratio that relates the obligations (interest, premium and amortisation) to the (family) income of the client. In most cases, banks rely on the assessment of the value of the collateral by independent experts (although sometimes internal estimations are also used). Furthermore, an increasing number of banks use scenario analyses to determine the potential effects of external changes (interest rates, economic cycle) on their mortgage portfolio.

The involvement of public chartered institutions in housing finance is limited. Most noteworthy is the Nationale Hypotheek Garantie (NHG), a national mortgage loan guarantee facility. The NHG facility, which only applies for mortgages up to a nominal amount of EUR 240,000, aims at stimulating home ownership by protecting homeowners against the risk of running into debt servicing problems due to unemployment, divorce etc. If structural repayment problems for homeowners arise, the NHG facility will cover the mortgage payments to the bank. Hence, this facility reduces banks' credit risk stemming from mortgage loans up to EUR 240,000. Ultimately, the facility is covered by the Dutch federal

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[4] For more information on the increasing significance of securitisation, see *DNB Statistical Bulletin*, December 2003.

government and municipalities. Since 1998, the NHG also insures purchasers against a fall in house prices: if the borrower is forced to sell the house due to long-term illness, unemployment, divorce, etc, the NHG will make up any difference.[5]

With respect to funding practices, there are no special regulations or laws. Banks are allowed to fund themselves through deposits (ie interbank and customer deposits) or through financial markets (ie mortgage bonds, subordinated debt and mortgage-backed securities).

## Regulation

The Netherlands Authority for the Financial Markets (AFM), responsible for supervising the operation of financial markets in the Netherlands, has set regulations on the information that mortgage lenders have to provide. For instance, the AFM looks at various financial advertisements to ensure that they are not misleading and has the possibility to intervene or to impose sanctions. Moreover, since 1 July 2002, financial institutions have been obliged to provide a Financial Information Leaflet to consumers who are considering purchasing complex financial products. Complex financial products consist of a combination of investment and, for example, insurance or a loan. The leaflet explains the nature of the product and the most significant associated risks and must comply with various standards. The leaflet is obligatory for investment mortgages, although it is been assessed whether it should also be provided for all mortgage contracts. Moreover, the mortgage branch itself has compiled a number of guidelines and best practices (Mortgage Code of Conduct).

In the Netherlands, there is full recourse against borrowers who have defaulted on mortgage payments. Under the Civil Code and Code of Civil Procedure, a lender in the Netherlands is allowed to apply for an attachment to the borrrower's income at any stage during the foreclosure process. This allows the lender legal recourse to a proportion of the borrower's salary and other income, by judicial decision. In addition, if there is an outstanding loss after the foreclosure process, the lender can, again through court order, seize a borrower's assets for an indefinite period to recoup the loss. These forms of legal protection for lenders act as a strong disincentive to default and limit the potential losses of lenders.

An investigation in 2000 by the Nederlandsche Bank revealed certain shortcomings in the quality of the administrative organisation of mortgage providers (mainly banks). These were due to the steep increase in the number of mortgages extended, product innovation, an increase in the complexity of certain products and higher demands placed on IT systems. As a consequence, the Nederlandsche Bank has intensified its focus in the supervision of these institutions on the quality of their administrative organisation.

The current solvency requirements for Dutch banks regarding the treatment of mortgages provide for a distinction according to the (perceived) riskiness of the loan. Mortgage loans guaranteed by the NHG have a risk weighting of 0. Mortgage loans that do not exceed 75% of the liquidation value of the property have a risk weighting of 50%. When the mortgage loan exceeds 75% of the liquidation value of the property - so called *top mortgages* -, the "loan surplus" on top of the liquidation value will have a risk weighting of 100%.

## International links

The presence of foreign financial institutions in the Dutch mortgage lending market has been insignificant, with a market share of less than 0.5%.[6] However, foreign banks have expanded their mortgage activity in the Netherlands remarkably, with a growth rate of over 50% in 2003. This is largely due to competitive pricing of mortgages via the internet and possibly also to more favourable lending criteria in comparison with other mortgage providers. In 2004, the high growth rate continued.

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5 As of end-2004, more than 450,000 mortgage loans were covered by NHG. Furthermore, the number of households that applied for the NHG facility has increased rapidly from 41,000 in 2000 to 77,000 in 2003 and 96,000 in 2004. In 2004, the number of households under the NHG that were in arrears with their mortgage payments for four months or more increased to 1,743 (2003: 1,246). The number of forced home sales with a loss increased from 179 in 2003 to 331 in 2004.

6 This figure does not include the Belgian-Dutch bank Fortis, the fourth largest bank in the Netherlands, with a significant share in the mortgage market.

Some Dutch banks undertake considerable mortgage lending activity in foreign countries as a result of acquisitions there. For instance, a significant part of ABN Amro's profits stems from retail activities, in particular mortgage lending, in the United States and Brazil. Other activities being undertaken by the largest Dutch banks abroad are corporate finance (M&A, underwriting, privatisations, debt, equity, syndications, IPOs), asset management (discretionary and non-discretionary fund management - pooled, segregated, open funds) and trading and sales (fixed income, equity, FX, commodities, own position securities, repos, prime brokerage).

The involvement of international ratings agencies in the Netherlands is considerable. In their credit assessment, medium-sized and small banks tend to rely to a certain extent on information from and assessments by ratings agencies, in particular Moody's, Standard & Poor's and Fitch. In addition, larger banks rely heavily on ratings agencies when issuing for instance mortgage-backed securities.

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